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SENSITIVE

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SUBJECT: Update on Turkey BOT Power Plants

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Sensitive But Unclassified. Please Handle Accordingly.

¶1. (SBU) Summary. The importance for Turkey of honoring its "BOT" contracts with independent power projects despite their high cost has been on the U.S.-Turkey economic agenda since the beginning of this decade. Despite public blustering and pressure on the companies to reduce prices, the government has allowed the plants to operate and has not taken any unilateral confiscatory or expropriatory action. The government and the companies are currently negotiating contract changes, but even if these negotiations are mainly intended for public consumption, it is unlikely that the government -- which needs to attract substantial foreign and domestic private investment in generating capacity over the next few years -- will take dramatic action against the companies, which continue to involve substantial, though declining, U.S. financial interests. End Summary.

The Longstanding Issue of BOTs

¶2. (SBU) Since the late 1990s, the Turkish government has grappled with the financial and domestic political problems presented by "take or pay" contracts that require it to purchase electricity from privately developed independent power projects (IPPs) at high guaranteed prices. At several points, especially during and immediately after the 2000-01 financial crisis, Turkish officials threatened to unilaterally alter or abrogate these contracts. At other times they have applied strong legal and regulatory pressures, often amounting to harassment, in unsuccessful efforts to convince IPP sponsors to agree to changes in contract terms. With several of the plants having public and private U.S. debt and equity exposure, U.S. officials have continually urged Turkey not to take any actions that would call into question the principle of "contract sanctity" and thereby further damage Turkey's already fragile business and investment climates as well as U.S. commercial interests.

BOT'S Become Political Issue

¶3. (SBU) BOT's (Build-Operate-Transfer) account for 40% of the country's current electricity generation and 25% of installed capacity. Especially in the context of severe government spending austerity since the financial crisis, the contracts have become a sensitive political issue. Popularity-seeking politicians have made repeated promises to reduce electricity prices paid by businesses and consumers, while the sensationalist, nationalistic press constantly goads the government and public on the issue.

¶4. (SBU) Two BOT gas-fired IPPs, Trakya Elektrik and Doga Enerji, have attracted the most controversy. Although the plants have never been issued formal licenses, the government has allowed them to operate at full capacity under the existing contracts. Thus, GOT has taken and paid for the electricity produced per the take-or-pay contracts. However, in an apparent effort to pressure the companies, Turkish officials have subjected them to intrusive tax and financial inspections that the companies claim -- and Turkish officials will privately admit -- has at times amounted to harassment. At several points, the press has reported that the government intended to seize the plants. The most recent such reports, in October 2003,

were denied by the Energy Ministry.

Mood Turns Toward Negotiations

¶5. (SBU) More recently however, Turkish government officials have adopted a different tone and apparently a different approach to the problem, although the investigations of potential "misconduct" continue (ref B). Turkish officials tell us they recognize the importance of not abrogating existing contracts. Instead, they say they are looking for negotiated "solutions," and have called for "voluntary reductions" from four existing BOT projects that would be negotiated between the government and investors. The GOT and companies have recently entered into negotiations for a compromise, although companies continue to report an excess of inspection and pressure to unilaterally cut prices.

¶6. (SBU) In late December 2004, the Energy Ministry initiated negotiations with the BOT sponsors to seek a solution to the BOT conundrum that does not disturb investors. While citing the value of contract sanctity, the MENR called for a voluntary reduction in price in recognition of the changed market circumstances. The BOT companies, quite naturally, remain suspicious. A company official told us that the Ministry implicitly threatened to pursue the results of financial and customs inspections, without revealing any potentially incriminating information it might have. The Ministry initial set a public deadline of January 15 for company offers and a determination to solve the BOT problem by May. Without making any "offers" on prices, the companies all sent letters to the Ministry prior to January 15 asserting their steadfast adhesion to contract provisions and good faith intentions to seek a compromise with the Ministry of Energy -- as a contract partner. The companies say they now expect to receive a "reference price" from the Ministry for discussion purposes and note that all their foreign partners' and creditors' assent would be needed for any deal. A senior Turkish energy official told us that the government did not really expect the negotiations to result in significant contract changes, but that politicians needed to be "doing something" that they could point to with constituents.

Goal of Market Liberalization

¶7. (SBU) Budak Dilli, MENR Energy Affairs DG, reaffirmed to us on January 7 that the GOT would not seek to unilaterally amend or cancel the contracts with BOT's, noting the need to assure a transparent investment environment, based on rule of law, which would attract needed new capital. He emphasized that the GOT was committed to moving to a liberalized market, with reduced public obligations. Moreover, Dilli stated that no matter how tough the investment conditions were at the time these projects were launched, the contracts were badly designed and too expensive. Dilli said that the parties needed to understand the changed situation and each others' positions and work together to reach a compromise. Energy Under Secretary Sami Demirbilek reiterated these points in a January 28 meeting (ref A).

¶8. (SBU) The Ministry says that its objective is to transition the energy sector to a liberal, market-driven model, with which the high fixed price BOT contracts are inconsistent. Dilli noted that the GOT was working closely with the World Bank on an Electricity Strategy Paper. He admitted that there had been some delays, but he asserted that this showed that the GOT was serious about laying adequate preparations for successful liberalization and privatization of the distribution and production facilities. He described the challenges as three-fold: a) attracting new investors given projections for increased energy demand, b) establishing a new investment model that did not depend on sovereign guarantees, and c) formulating a smooth transition from the old system - with the baggage of some "bad" contracts - to a new liberalized system - without scaring off potential investors. Dilli emphasized that transparency, an efficient legal system, and minimized regulatory risk were vital for investor confidence and liberalization.

Declining U.S. Exposure

¶9. (SBU) Meanwhile, U.S. private financial exposure

to the plants has been declining. In particular, the U.S. Edison Mission company is reportedly selling its interest in the 180 MW Doga Energi BOT project to a non-U.S. investor. Similarly, we understand that Bechtel and Shell are selling their interest in the three "Intergen" BO projects (Adapazari - 777 MW, Gebze - 1554 MW, Izmir- 1550 MW) to their Turkish partner, ENKA. Finally, we have heard that Prisma, as the successor to Enron, may be interested in divesting itself of its interest in the 480 MW "Trakya Electrik" BOT project. Both EXIM and OPIC, however, may continue to have exposure to these projects. In addition, EXIM has credit outstanding to Turkish owned Baymina and Zorlu (a corporate generating facility) projects.

Comment

¶10. (SBU) The issue of the BOT's appears to have found a reasonably steady equilibrium. The projects continue to operate according to their contracted terms and the risk of unilateral action by the government is still present, but is considerably less than it may have been earlier in the decade. Contributing to this has been the government's recognition that confiscatory action would be contrary to its need to encourage private foreign investment in the energy sector needed to meet growing electricity demand, which could exceed supply by 2007 according to some projections. Also, the period of highest prices under the contracts has been passed. There was 15% price step-down in 2005 and there will be another in 2009. While the local companies remain wary, they accept that they continue to operate and receive their return on investment.

¶11. (SBU) Thus, Embassy does not believe that the Turkish government will resort to outright contract abrogation or seizure, as it is increasingly mindful of the importance of rule of law to attract badly needed foreign investment. As Turkey moves further towards market based liberalization, it faces a special challenge in assuring transparent contract-based treatment of previous guaranteed (shielded from the market) obligations. Although the country's lively and unrestrained press will continue to (mis)inform and exaggerate contentions, it seems to Post that the period of greatest risk has passed, but we will continue to monitor the situation closely.
Edelman